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Supreme Court, U.S.
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No. 02-1272

IN THE
SUPREME COURT OF THE UNITED STATES

ROSEMARY DePAOLI
and FRANK KRESOCK,

Petitioners,

v.

UNITED STATES OF AMERICA,

Respondent.

Petition for Writ of Certiorari
To the United States Court of Appeals
for the Third Circuit

PETITIONERS' REPLY TO BRIEF IN OPPOSITION

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ARGUMENT IN REPLY

Rosemary DePaoli and Frank Kresock have petitioned this Court for a writ of certiorari to review the judgment and opinion of the Third Circuit. The court below held that to convict them of tax evasion, the government did not have to prove their unreported receipts were, under the Internal Revenue Code, taxable as "income." The respondent does not deny that there is an entrenched split in the circuits over this question. Nor does the respondent attempt to defend in any way the reasoning or conclusion of the court below or of the other circuits it followed. The Brief in Opposition takes a different tack: it refuses to address the question presented,[1] and instead advances several arguments -- none of them raised by the government in the trial court or in the court of appeals, nor by either court *sua sponte* -- in support of its theme that the question proposed in the Petition is not presented on the facts and record of this case. Because the respondent's attempts to avoid the question presented miss the mark, the petition should be granted.

The brief in opposition ("Br.Opp.") proposes two reasons why certiorari should be denied. First, the respondent attacks the legal correctness of the Second Circuit rule on which the petitioners relied below, and which they advocate before this Court. Br. Opp. 6-7. Second, the respondent contends that for various reasons

[1] The respondent also proposes a revision of the Question, Br.Opp. (i), to make it seem more fact-specific and the case accordingly less worthy of this Court's attention. The Question Presented in the Petition, of course, is the one the Court would and should address if the writ is granted.

arising from the record of this case, the Second Circuit rule was either not available to petitioners or would not have benefited them even if it had been applied. Br.Opp. 7-9. These contentions are not persuasive and do not justify denial of the petition.

1. The Second Circuit's *Leonard-D'Agostino* rule is correct, both under the law of taxation of corporate dividends and as a general matter of criminal tax evasion law, although other circuits disagree.

Petitioners' defense to the tax evasion counts was built in part around their reliance on the decision in *United States v. D'Agostino*, 145 F.3d 69 (2d Cir. 1998). The *D'Agostino* opinion does not founder on any careless failure by those judges to read and apply the applicable provision of the Internal Revenue Code, as the respondent appears to suggest. Br.Opp. 6, pointing to 26 U.S.C. (IRC) § 316(a)(1) (dividend is corporate disbursement to shareholder out of "earnings and profits," which may have accumulated in prior years).[2] Rather, *D'Agostino* follows Judge Friendly's leading decision in *United States v. Leonard*, 524 F.2d 1076, 1083-84 (2d Cir. 1975), and it was followed in turn by *United States v. Bok*, 156 F.3d 157, 161-64 (2d Cir. 1998). The fact that subsection 316(a)(1) was not separately discussed in *Leonard*, *D'Agostino* or their progeny in no way suggests the case was wrongly decided. In none of those cases was there the slightest suggestion that the corporation in question

[2] This statute was fully quoted and set forth in the Statute Involved section of the Petition. No one overlooked it, as the United States now implies.

had retained any accumulated "earnings and profits" from prior years, such that § 316(a)(1) might be in issue.

Nor was there any evidence or suggestion of accumulated prior-year profits in this case. Like virtually every small, family-owned corporation, professional or otherwise, Columbia Medical Group distributed all its income every year; if it had any extra, the record shows, it would grant bonuses or adjust the owners' loan accounts, not accumulate profits.[3] The books and records of CMG were all in the hands of the IRS and the U.S. Attorney's Office prior to and during trial. Neither the prosecutor nor any witness suggested that CMG had accumulated profits under § 316(a)(1). To cite that little-utilized provision[4] as if it were the secret Achilles heel of the *D'Agostino* doctrine is much ado about nothing.

Nor does the *D'Agostino* doctrine run afoul of the rule that taxpayers must live with the tax consequences, intended or otherwise, of their voluntary business choices. *See* Br.Opp. 7, quoting *Comm'r of Int. Rev. v. National Alfalfa Dehydrating & Milling Co.*, 417 U.S. 134, 148-49 (1974). The issue here concerns the treatment on petitioners' joint individual tax return(s) of the value of personal expenses paid for their benefit by their professional corporation. On the personal returns, as filed, the value of those benefits was not declared as income. This

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[3] To do otherwise is absurd; it only results in the proverbial "double taxation" which results from the application of a corporate income tax and then the individual income tax on the same profits when later distributed.

[4] *See* Boris I. Bittker & James S. Eustice, *Federal Income Taxation of Corporations and Shareholders* ¶8.02[4], at 8-14 to -15 (7th ed. 2000 & 2001 Supp.).

conduct can give rise to a prosecution for tax evasion under 26 U.S.C. § 7201 only if, *inter alia*, this omission evidences an attempt to evade "a tax imposed by this title." *Id.*

Is a tax imposed by Title 26 on such amounts? Only if they were received by the owners as miscellaneous (imputed) income or as (constructive) dividends. There would be no tax due, and thus no evasion, if the corporation's covering the owners' expenses served to reduce a loan balance existing in their favor as the corporation's creditors, for example. (There was unconstested evidence that a signficant loan balance of that kind existed in this case.) Nor is the undeclared value taxable as "income" if it constituted a return of capital, rather than dividends, where the corporation had no "earnings and profits." Boris I. Bittker & James S. Eustice, *Federal Income Taxation of Corporations and Shareholders* ¶8.02[5], at 8-15 to -17 (7th ed. 2000 & 2001 Supp.).

Nothing about the mischaracterization of the payments on the corporation's tax returns inevitably leads to one result or the other on the owners' personal returns, where the payments were not characterized at all. If CMG's accountant had characterized the corporation's expenditures on behalf of its owners as "loans," or as "advances" on anticipated bonuses, or as repayments of existing loans to the corporation, then one or another tax consequence would flow from that characterization, assuming the actual facts were consistent with it. *Higgins v. Smith*, 308 U.S. 473, 477 (1940). But here there was no characterization. The issue is purely statutory, as the Second Circuit's cases rightly hold.

If the distributions to the owners during the year came out of the corporation's "earnings and profits,"

viewed in retrospect as of the end of the year, they amounted to taxable dividends. IRC § 316(a)(2). If the corporation had no "earnings and profits" that year (and hadn't paid the expenses out of prior-year accumulated earnings and profits, *id.* § 316(a)(1)), then the value of the payments constituted a return of capital, or a repayment of loans, and in either event did not create taxable income. The appearance (or bookkeeping characterization) of the expenditure, when made, may have to be altered after the fact, depending upon whether the corporation, when the year is done, is found to have had "earnings and profits." Bittker & Eustice, *supra* ¶8.02[2], at 8-12. Since the existence of a "deficiency" *vel non* depended in this case on that fact, the matter should have gone to the jury, as the defense requested.

The Second Circuit cases, as the defense contended at trial and on appeal, state the law correctly -- both the law of income taxation and the law of criminal tax evasion. The other circuits which disagree, followed by the court below, do so on illogical and indefensible grounds, as the Petition shows (pp. 17-21). Indeed, the total absence of any effort by the United States to defend the reasoning of the anti-*D'Agostino* circuits (including that of the court below) speaks volumes. The split in the circuits is real, the rule on which petitioners rely easily survives the pot-shots that the respondent directs at it,[5] and the conflicting, majority position -- endorsed by the court below -- does not withstand even modest scrutiny. Accordingly, the writ should be granted.

[5] Even if the Second Circuit analysis were wrong, that would be no reason to deny certiorari. The Court should still grant certiorari to see that the correct rule is followed in all circuits.

2. The respondent's attempts to find flaws in the record to avoid a grant of *certiorari* in this case have no merit.

The respondent opposes a grant of certiorari in this case on several other trivial and erroneous bases, all in attempted avoidance of the merits. First, it contends that the petitioners' requested jury instruction on the *D'Agostino* issue misstated the law, even under the Second Circuit's view. Br.Opp. 7-8. Neither the prosecutor nor the district court objected to the proposed instruction on this basis. *See* CA3 App. 169-70. The trial court never got as far as the precise phraseology of the requested instruction because it rejected the entire referenced principle out of hand. Likewise, the respondent's present point was never made by the government before the court of appeals, nor by the appellate panel in its decision. Arguments that should have been raised during trial, that is, at the charging conference, but were not, are not appropriately raised for the first time in this Court. See *Steagald v. United States*, 451 U.S. 204, 209 (1981) (principle applied against the government by this Court in a criminal case); accord, *Granfinanciera, S.A. v. Nordberg*, 492 U.S. 33, 38-39 (1989).

The respondents' second fact-specific point is the claim that "there was an inadequate factual basis in the record for petitioners' requested instruction." Br.Opp. 8. This contention is based only on the brief passage cited in the petition. But in addition to the oral testimony, the evidentiary record at trial included CMG's records and those of its accountant.[6] From all the documents, and in

[6] The government's trial exhibits, frequently referred to before the jury by all parties with several witnesses, included CMG's

light of the accountancy testimony, the jury could easily have concluded that the corporation lacked "earnings and profits" in each relevant year, and that it had accumulated none in prior years.[7]

Finally, the respondent attempts to dispute the defense expert's testimony that the corporation actually had no "earnings and profits," by claiming he made a fundamental mistake. Respondent asserts that the defense expert -- a CPA who was a retired, long-time, supervisory IRS examination agent -- wrongly in his hypothetical analysis deducted the corporation's distributions to petitioners prior to computing the "earnings and profits." Br. Opp. 8-9, citing 26 U.S.C. § 316(a)(2).

But the defendant's expert did not make the basic mistake charged to him by the respondent. The expert stated that if CMG "had issued 1099s, *the 1099 would have been deductible* by the corporation, assuming the deductions were proper, and the 1099 issuance would have created the *expenses* which would then result in the corporation['s] having no taxable income ...." 11/19/99 Tr. 113. In other words, the corporation took no deductions to which it was not entitled; it simply recorded them

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cash disbursements journals, general ledgers and financial statements for the years in question, as well as its tax returns. Gov't Exh. 21-29.

[7] Respondent repeats the Third Circuit's endorsement of the district court's attempt to distinguish *D'Agostino* on the basis that the government had conceded there that the corporation had no "earnings and profits." Br.Opp. 5. Understandably, however, respondent does not actually try to defend the proposition that the defense is not entitled to a jury instruction relating to factual issues which are reasonably in dispute.

inaccurately, apparently for the convenience and benefit of the owners. The expert's references to "1099s" -- the number of the IRS form on which a business reports the payment of miscellaneous income (beyond salary), rents (to the petitioners in their capacity as CMG's landlord), interest on loans, or cancellation of debt, *inter alia* -- coupled with his reference to "expenses" (that is, "ordinary and necessary [business] expenses" of the corporation under IRC § 162(a)) suggest that the expert was referring to payments of kinds other than dividends which, because they *do* constitute deductible expenses, *do* reduce or (very often) eliminate the margin of a corporation's "profit."

This has nothing to do with the circuit split over whether an "earnings and profits" analysis is appropriate before charging a defendant with failure to report constructive dividends. On that score, the defense expert was correct; CMG had little or no taxable income on the same basis that it had no "earnings and profits." Section 316 quite clearly is concerned only with "distributions" made during the year, not with other sorts of "expenditures." (The requirement to disregard any distributions made during the year avoids circularity and thus undermeasurement of the profits.) There is no reason to suppose that the defense expert was so ignorant or careless that he would have been referring in this passage to payments of *dividends* made during the year (that is, to "distributions") -- which would indeed have been erroneous.[8]

[8] Surely, if the prosecutor at trial had thought the defendant's expert was vulnerable to attack on so basic a matter of tax knowledge, he would have made a point of it on cross-examination, or would have called a rebuttal witness. But in

In short, the respondent not only fails to discuss or dispute the genuine split in the circuits on the important issue of criminal tax law presented, it tries to avoid this Court's addressing the issue in the present case with fact-specific claims which are not borne out by the record and which were never advanced by the government in either court below. In all these ways, the respondent's position falls short. The petition for certiorari should be granted.

CONCLUSION

For the foregoing reasons, and for the reasons discussed more fully in the petition itself, this Court should grant the petition of Rosemary DePaoli and Frank Kresock for a writ of certiorari to review the judgment and opinion of the United States Court of Appeals for the Third Circuit upholding their convictions for attempted evasion of income tax.

Respectfully submitted,

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fact the prosecutor did neither. *See* 11/19/99 Tr. 118-33 (cross-examination); 11/30/99 Tr. 118 (no rebuttal).